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The California Public Employees' Retirement System
Annual Investment Report—Year Ended June 30, 1998

INVESTMENT COMMITTEE
CHAIR'S MESSAGE

On behalf of the CalPERS Board of Administration, I am pleased to present our Annual Investment Report for the fiscal year ended June 30, 1998.

This report provides an overview of the Fund's investment performance and presents highlights and statistics of our investment programs and portfolios.

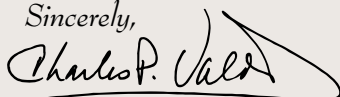
The 1997-98 fiscal years marked the fourth year of double-digit returns since the CalPERS Board of Administration's decision to invest more of the fund's assets into the U.S. and international equity markets. We earned a 19.5 percent return on our investments, ranking CalPERS performance 25th—or top quartile—versus the Trust Universe Comparison Service (TUCS) peer group of public pension funds with assets over \$1 billion. The Fund's total investment portfolio market value at June 30, 1998 was \$143.3 billion, \$23 billion higher than one year ago.

During the year, we maintained a sound investment strategy, diversified our portfolio, and to a lesser extent, searched out bargains in the volatile equity market. We implemented comprehensive investment strategies in our domestic equity, real estate, and alternative investment and private equity portfolios. We sharpened our focus on value added private equity investments that build business. We partnered with new real estate firms that will co-invest alongside CalPERS, providing us with greater alignment of interests. We made our first international real estate investment that will help us capture greater returns abroad. We adopted a set of corporate governance principles and guidelines for the United States that we hope will serve as the foundation for greater accountability and independence. We continued to invest in our state, providing a powerful economic stimulus to California's growth.

Our success during the year can be attributed to prudent and wise investment decisions. A recent study concluded that investment decisions made by CalPERS earned the System an extra \$2 billion in 1997 over and above the Fund's projected returns. Our value-added performance exceeded 91 percent of other large public and private pension funds, and did so at a lower cost than last year.

Over the next year, CalPERS Board will continue to seek out safe and prudent investments for the long-term benefit of the Fund. We will manage our investments so we are well prepared to meet our benefit obligations into the 21st century. We will ensure a financially secure retirement for all our members and their beneficiaries for years to come.

Sincerely,



CHARLES P. VALDES, CHAIR
INVESTMENT COMMITTEE



CALPERS BOARD OF ADMINISTRATION

WILLIAM DALE CRIST, *President*
CHARLES P. VALDES, *Vice President*
RONALD ALVARADO
ROBERT F. CARLSON
THOMAS J. CLARK
KATHLEEN CONNELL
MICHAEL FLAHERMAN
MATT FONG
MIKE QUEVEDO, JR.
WILLIAM ROSENBERG
KURATO SHIMADA
JOSEPH A. THOMAS
DAVID TIRAPELLE

INVESTMENT COMMITTEE

All members of the Board serve on the Investment Committee. Charles P. Valdes serves as the Committee Chair and William D. Crist is Vice Chair. This Committee reviews investment transactions, the work of staff and consultants, and establishes investment strategy and asset allocation.

CALPERS EXECUTIVE STAFF

JAMES E. BURTON
Chief Executive Officer
JAMES H. GOMEZ
Deputy Executive Officer
SHERYL PRESSLER
Chief Investment Officer
Investment Office
ROBERT AGUALLO
Assistant Executive Officer
Investment Office
VINCENT P. BROWN
Assistant Executive Officer
Financial & Administrative Services
KAYLA J. GILLAN
General Counsel
BARBARA HEGDAL
Assistant Executive Officer
Member & Benefit Services
PATRICIA K. MACHT
Chief, Office of Public Affairs
RON SEELING
Chief Actuary
Actuarial & Employer Services
MARGARET STANLEY
Assistant Executive Officer
Health Benefit Services
ROBERT D. WALTON
Assistant Executive Officer
Governmental Affairs,
Planning & Research

CONSULTANTS

WILSHIRE ASSOCIATES
Pension Consultant
PENSION CONSULTING ALLIANCE/
KENNETH LEVENTHAL & CO.
Real Estate Consultant
HAMILTON LANE ADVISORS, INC.
PACIFIC CORPORATE GROUP, INC.
Alternative Investment Management
Program

CUSTODIAN

STATE STREET BANK AND TRUST
COMPANY

MAINSTREAM DOMESTIC ACTIVE EQUITY MANAGERS

BRINSON PARTNERS, INC.
BROWN CAPITAL MANAGEMENT, INC.
DRESDNER RCM GLOBAL
INVESTORS, LLC
GEEWAX, TERKER & COMPANY
GOLDMAN SACHS ASSET
MANAGEMENT
OAK ASSOCIATES, LTD.
OPPENHEIMER CAPITAL
MANAGEMENT
STATE STREET BANK AND TRUST
COMPANY
THE BOSTON COMPANY ASSET
MANAGEMENT, LLC
THE PUTNAM ADVISORY COMPANY,
INC.
UNITED STATES TRUST COMPANY
OF NEW YORK

**MAINSTREAM DOMESTIC
PASSIVE EQUITY
MANAGERS**

DIMENSIONAL FUND ADVISORS, INC.

**SMALL & EMERGING
DOMESTIC EQUITY
MANAGERS**

AMERINDO INVESTMENT
ADVISORS, INC.

SPARE, KAPLAN, BISCHER &
ASSOCIATES, INC.

VALENZUELA CAPITAL PARTNERS,
LLC

VALUEQUEST/TA, LLC

**INTERNATIONAL FIXED
INCOME MANAGERS**

BARING INTERNATIONAL
INVESTMENT, LTD.

FIDUCIARY TRUST COMPANY
INTERNATIONAL

JULIUS BAER INVESTMENT
MANAGEMENT, INC.

MERCURY ASSET MANAGEMENT
INTERNATIONAL, LTD.

**GLOBAL TACTICAL ASSET
ALLOCATORS**

BRINSON PARTNERS, INC.

**INTERNATIONAL PASSIVE
EQUITY MANAGERS**

STATE STREET GLOBAL ADVISORS

**INTERNATIONAL ACTIVE
EQUITY MANAGERS**

MORGAN GRENFELL INVESTMENT
SERVICES, LTD.

NEWPORT PACIFIC MANAGEMENT,
INC.

NOMURA CAPITAL MANAGEMENT,
INC.

OECHSLE INTERNATIONAL
ADVISORS, L.P.

PARIBAS ASSET MANAGEMENT, INC.

SCHRODER CAPITAL MANAGEMENT
INTERNATIONAL, INC.

VALUEQUEST/TA, LLC

**CURRENCY OVERLAY
MANAGERS**

BEA ASSOCIATES

PERITO PARTNERS

STATE STREET BANK AND TRUST
COMPANY

**REAL ESTATE ADVISORS &
PARTNERS**

AMB INSTITUTIONAL REALTY
ADVISORS, INC.

BANKERS TRUST CO.

BURNHAM PACIFIC RETAIL
PROPERTIES

CNL INSTITUTIONAL ADVISORS,
INC.

COMPASS MANAGEMENT

COMMONWEALTH PACIFIC

E & Y KENNETH LEVENTHAL

GE CAPITAL INVESTMENT
ADVISORS, INC.

GENERAL INVESTMENT &
DEVELOPMENT ADVISORS, CO.

HANCOCK TIMBER RESOURCE GROUP

HEARTHSTONE HOUSING
PARTNERS, L.P.

HINES INTERESTS

IBEX INSTITUTIONAL ADVISORS

INSTITUTIONAL HOUSING
PARTNERS, L.P.

KENNEDY ASSOCIATES REAL
ESTATE COUNSEL, INC.

LA SALLE ADVISORS CAPITAL
MANAGEMENT, INC.

LEND LEASE REAL ESTATE
INVESTMENTS, INC.

MACFARLANE PARTNERS

MILLER CAPITAL ADVISORY, INC.

OLYMPIC REALTY ADVISORS

PICAL, L.P.

PRUDENTIAL HOME BUILDING
INVESTORS, INC.

RREEF

RESIDENTIAL R.E. PARTNERS, L.P.

SENTINEL REAL ESTATE
CORPORATION

SSR REALTY ADVISORS

THE NEWLAND GROUP, INC.

WESTMARK REALTY ADVISORS

WFHAI HOUSING FUND, L.P.

WELLS FARGO HOUSING ADVISORS,
INC.

WEYERHAEUSER CORPORATION
W. P. CAREY & CO., INC.

S U M M A R Y O F S E C U R I T I E S O W N E D

As of June 30, 1998

CATEGORY	BOOK VALUE	MARKET VALUE	% OF INVESTMENTS AT MARKET VALUE
CASH EQUIVALENTS & NET RECEIVABLES/PAYABLES			
Domestic Cash Equivalents			
Internal Domestic Cash Equivalents			
Cash Equivalents	\$2,538,575,840	\$2,538,575,840	1.77%
State Pooled Money Investment Fund	374,333,000	374,333,000	0.26%
U.S. Treasuries & Agencies	9,892,858	9,894,300	0.01%
Total Internal Domestic Cash Equivalents	\$2,922,801,698	\$2,922,803,140	2.04%
External Domestic Cash Equivalents			
Cash Equivalents	\$245,732	\$245,732	0.00%
U.S. Treasuries & Agencies	33,222,282	33,222,282	0.02%
Total External Domestic Cash Equivalents	\$33,468,014	\$33,468,014	0.02%
Total Domestic Cash Equivalents	\$2,956,269,712	\$2,956,271,154	2.06%
External International Cash Equivalents			
International Currency	\$167,420,069	\$167,496,208	0.12%
Net Investment Receivables/Payables	(\$40,339,604)	(\$40,339,604)	(0.03%)
TOTAL CASH EQUIVALENTS & NET RECEIVABLES/PAYABLES	\$3,083,350,177	\$3,083,427,758	\$2.15%
FIXED INCOME			
Domestic Fixed Income			
Internal Domestic Fixed Income			
Mortgaged-Backed Securities:			
CMO	\$8,998,785,719	\$9,605,230,302	6.70%
FHLMC	1,447,432,344	1,503,638,842	1.05%
FNMA	1,886,002,241	1,947,568,498	1.36%
GNMA/GNMA MHLF	23,386,309	25,276,300	0.02%
U.S. Treasuries & Agencies:	4,061,564,799	4,482,852,373	3.13%
Corporate:			
Private	590,669,049	685,812,639	0.48%
Public	9,068,756,070	9,994,204,690	6.98%
Sovereign	777,331,868	907,166,961	0.63%
Various Internal Fixed Income	94,624,326	94,598,074	0.07%
Private Mortgages:			
Commercial Mortgage Pools	121,341,692	130,909,567	0.09%
Commercial Whole Loans	1,200,284,236	1,300,404,700	0.91%
Single Family Participating Certificates	1,497,333	1,843,039	0.00%
Inflation Protected Securities	554,245,159	545,663,444	0.38%
Special Investments:			
Member Home Loan Programs:			
FNMA (Deliverables)	680,847,645	684,011,582	0.48%
FNMA (Non-Deliverables)	234,719,594	245,658,278	0.17%
Jumbo	258,034,769	258,866,171	0.18%
Retirement Account Loans	37,849,560	37,849,560	0.03%
Retirement Account Loans Defaulted	715,603	715,603	0.00%
AFL-CIO HIT	82,897,970	85,446,771	0.06%
Bridge Housing	5,684,295	5,684,295	0.00%
Equitable CCMF	26,823,424	29,003,299	0.02%
ULLICO	47,810,653	49,569,749	0.03%
Total Internal Domestic Fixed Income	\$30,201,304,658	\$32,621,974,737	\$22.77%

Summary of Securities Owned, continued

CATEGORY	BOOK VALUE	MARKET VALUE	% OF INVESTMENTS AT MARKET VALUE
FIXED INCOME (CONTINUED)			
External Domestic Fixed Income			
Mortgaged-Backed Securities:			
FNMA	\$3,149,967	\$3,342,180	0.00%
U.S. Treasuries & Agencies	69,305,755	70,191,451	0.05%
Various External Fixed Income	13,410,806	13,767,084	0.01%
Total External Domestic Fixed Income	\$85,866,528	\$87,300,715	0.06%
Total Domestic Fixed Income	\$30,287,171,186	\$32,709,275,452	22.83%
External International Fixed Income	4,722,189,944	4,785,628,952	3.34%
TOTAL FIXED INCOME	\$35,009,361,130	\$37,494,904,404	26.17%
EQUITY			
Domestic Equity			
Internal Domestic Equity			
Corporate Stock:			
Index Fund	\$16,912,504,571	\$52,024,632,307	36.31%
Other Funds	1,880,724,815	1,868,481,985	1.30%
International	21,399,368	15,465,087	0.01%
Preferred Stock:			
Index Fund	7,685,247	9,635,217	0.01%
Other Funds	214,950	—	0.00%
Convertible Securities:			
Bonds	184,441,251	193,450,287	0.14%
Preferred			
Other Funds	167,815,829	192,025,322	0.13%
Total Internal Domestic Equity	\$19,174,786,031	\$54,303,690,205	37.90%
External Domestic Equity			
Corporate Stock	\$11,750,848,801	\$13,337,859,666	9.31%
Preferred Stock	5,085,453	4,305,000	0.00%
Convertible Securities:			
Bonds	13,959,909	13,170,600	0.01%
Total External Domestic Equity	\$11,769,894,163	\$13,355,335,266	9.32%
Total Domestic Equity	\$30,944,680,194	\$67,659,025,471	47.22%
External International Equity			
Common Stock - Unhedged	\$9,052,122,550	\$12,036,472,948	8.40%
Common Stock - Hedged	10,566,520,284	13,075,050,504	9.13%
Currency Options	9,361,144	5,205,680	0.00%
Total External International Equity	\$19,628,003,978	\$25,116,729,132	17.53%
Alternative Investment Management Program			
Private Equity:			
Co-Investments	\$201,401,285	\$172,607,044	0.12%
Direct Investments	252,499,955	398,180,179	0.28%
Limited Partnership:			
Domestic	2,668,799,268	3,027,931,063	2.11%
International	122,437,429	124,534,836	0.09%
Total Alternative Investment Management Program	\$3,245,137,937	\$3,723,253,122	2.60%
TOTAL EQUITY	\$53,817,822,109	\$96,499,007,725	67.35%

Summary of Securities Owned, continued

CATEGORY	BOOK VALUE	MARKET VALUE	% OF INVESTMENTS AT MARKET VALUE
REAL ESTATE PROGRAMS			
Core Real Estate Investments			
Real Estate Equities	\$2,787,421,580	\$2,501,316,380	1.75%
Real Estate Joint Ventures	1,507,439,773	1,237,784,647	0.86%
Commercial Mortgages	86,144,276	128,002,760	0.09%
Sale/Leaseback	86,450,613	86,450,613	0.06%
Other Mortgages/AFL-CIO Building	50,131,384	75,046,806	0.05%
Total Core Real Estate Investments	\$4,517,587,626	\$4,028,601,206	2.81%
Specialized Real Estate Investments			
Single Family Land Acquisition & Development Program	\$98,338,518	\$80,916,848	0.06%
Single Family Housing Program	246,690,833	246,690,833	0.17%
Cadillac Fairview	234,603,166	12,259,537	0.01%
Catellus Common Stock	258,447,271	348,645,516	0.24%
California Urban Investment Program	11,781,307	11,781,307	0.01%
Franchise Finance	173,147,689	188,421,659	0.13%
Hotel	38,711,211	38,907,860	0.03%
Kennedy Development	6,891,788	6,891,788	0.00%
Land	10,184,018	8,500,578	0.01%
Security Capital Global Realty	37,500,000	37,500,000	0.03%
Timberland	456,884,096	1,184,827,891	0.83%
Total Specialized Real Estate Investments	\$1,573,179,897	\$2,165,343,817	1.52%
TOTAL REAL ESTATE PROGRAMS	\$6,090,767,523	\$6,193,945,023	4.33%
TOTAL INVESTMENT VALUE	\$98,001,300,940	\$143,271,284,910	100.00%

NOTE:

Differences between Total Investment Value in the Summary of Securities and Total Investments shown on page 10 are due to differences in reporting methods. In accordance with GASB Statement No. 28, the financial statements include Securities Lending Collateral as part of Total Investments, which is not included here. The Summary of Securities also includes Net Investment Receivables/Payables that are not reported on page 10 in Total Investments.

P O R T F O L I O O F C A L I F O R N I A I N V E S T M E N T S

At Market Value—As of June 30, 1998

ASSET CLASS	CALPERS TOTAL PORTFOLIO <i>(Dollars in Millions)</i>	CALIFORNIA HOLDINGS <i>(Dollars in Millions)</i>	CALIFORNIA HOLDINGS % OF EACH PORTFOLIO & ASSET CLASS
REAL ESTATE			
Mortgages			
AFL-CIO Housing Investment Trust	\$85.4	\$3.3	4%
Participation Mortgage (Bridge Housing)	5.7	5.7	100%
Commercial (Whole Loans/MBS)	1,431.3	429.0	30%
California Community Mortgage Fund	29.0	29.0	100%
Member Home Loan Program	299.3	299.3	100%
ULLICO	49.6	49.6	100%
Total Real Estate Mortgages	\$1,900.3	\$815.9	43%
Equity			
Acquisition & Development Program	\$80.9	\$80.9	100%
AFL-CIO Building Investment Trust	75.0	17.6	23%
Bay Area Real Estate (Catellus)	348.6	197.8	57%
CNL Net Lease Program	188.4	29.3	16%
CUIP	11.8	11.8	100%
Equity	4,013.2	965.5	24%
Housing Development	246.7	246.7	100%
Kennedy	6.9	—	0%
Timber	1,184.8	16.2	1%
Security Cap Global	37.5	—	0%
Total Real Estate Equity	\$6,193.8	\$1,565.8	25%
TOTAL REAL ESTATE MORTGAGES & EQUITY	\$8,094.1	\$2,381.7	29%
EQUITIES			
Alternative Investments—Direct Component	\$570.8	\$40.9	7%
Alternative Investments—Partnership Component	3,152.5	605.0	19%
Domestic Equity	67,659.0	8,508.6	13%
International Equity	25,116.7	—	0%
TOTAL EQUITIES	\$96,499.0	\$9,154.5	9%
TOTAL REAL ESTATE & EQUITIES	\$104,593.1	\$11,536.2	11%
FIXED INCOME			
Domestic Fixed Income			
Cash Equivalents	\$3,123.8	\$ —	0%
Corporate Bonds	12,132.8	485.3	4%
Member Home Loan Program—FNMA/GNMA	937.1	937.1	100%
Mortgage Pass-Throughs/CMOs	13,077.6	2,613.1	20%
Treasury Bonds	4,553.1	—	0%
Miscellaneous Fixed Income Securities	108.4	—	0%
Total Domestic Fixed Income	\$33,932.8	\$4,035.5	12%
International Fixed Income	\$4,785.6	\$ —	0%
TOTAL FIXED INCOME	\$38,718.4	\$4,035.5	10%
RECEIVABLES/PAYABLES	(\$40.3)	\$ —	0%
TOTAL INVESTMENTS	\$143,271.2	\$15,571.7¹	11%

NOTE:

¹ Approximately \$15.9 billion has been committed for investment in California. The \$15.6 billion amount shown here represents investments to date.

INVESTMENT PERFORMANCE

Security for Today & Tomorrow

Returns Soared

The CalPERS Investment portfolio posted impressive gains during the 1997-98 fiscal year. The Fund's total investment portfolio market value at June 30, 1998 was \$143.3 billion, \$23 billion higher than one year ago. The System earned a return of 19.5 percent, falling just shy of last year's performance of 20.1 percent. CalPERS performance ranked the pension fund 25th—or top quartile—versus the Trust Universe Comparison Service (TUCS) peer group of public pension funds with assets over \$1 billion. It also marked the fourth year of double-digit returns since CalPERS Board of Administration's decision to invest more of the Fund's assets into the U.S. and international equity markets.

CalPERS and other investors during the year witnessed increased volatility in the equity markets. In the past half-dozen years, the Dow Jones Industrial average, and stocks generally, have enjoyed the greatest bull-run in American history. But stock prices during the 1997-98 fiscal year soared to record levels that some investors feared too high. Also, investors in American companies feared that economic problems throughout the Far East would ultimately hurt U.S. business. As a result, the U.S. and international equity markets sent investors on a roller-coaster ride.

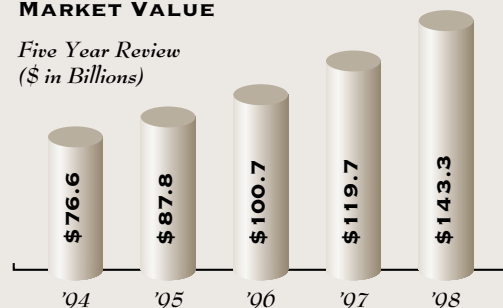
So how did CalPERS manage its investments and build a fund that would be well prepared to meet our

benefit obligations into the 21st century? We maintained a sound investment strategy, diversified the portfolio, and to a lesser extent, looked for bargains.

Despite the stock market turbulence, the Fund's U.S. stock holdings earned approximately 30 percent, matching the return of the Fund's benchmark the

GROWTH OF INVESTMENT PORTFOLIO MARKET VALUE

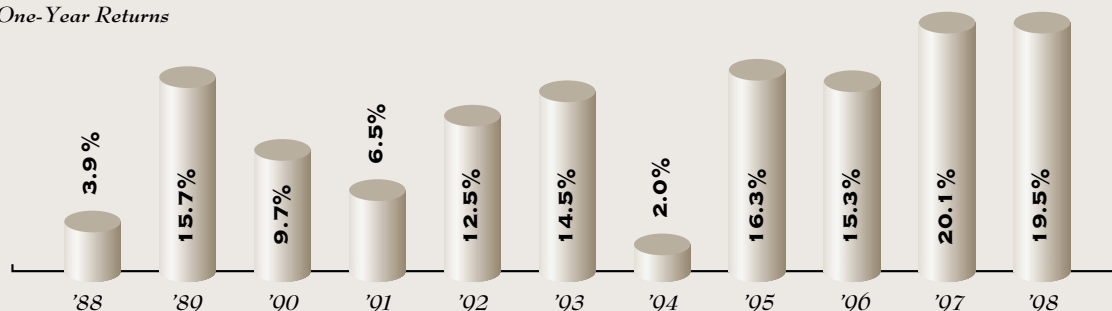
*Five Year Review
(\$ in Billions)*



Wilshire 2500. Our international equity portfolio also provided a solid return, gaining a 7.2 percent return, compared to a benchmark of 6.6 percent. By any measure, the volatility caused concern for investors. However, we acknowledged that U.S. economic fundamentals remained solid. Employment was up during the year, inflation remained low, and

TOTAL FUND PERFORMANCE

*Ten Year Review
One-Year Returns*



corporate earnings remained relatively strong. In this type of market, smart money was patient money. This philosophy proved successful, as we witnessed our total equity investments earn a 23 percent return.

Diversification for the most part helped to preserve gains in the portfolio and offset any losses in the equity markets. Our limited partnership and private equity investments returned nearly 36 percent, more than double the Fund's 15 percent benchmark. Likewise, our fixed income investments also outperformed its benchmark. Total fixed income investments returned 13 percent versus the Fund's benchmark of 11.8 percent. Our internally managed fixed-income investments returned 14.8 percent, beating the Salomon Brothers Large Pension Fund Index of 13.8 percent, while our domestic fixed-income investments returned 14.3 percent. Our international bonds outpaced the Salomon Brothers non-U.S. Government Index, returning 4.9 percent versus 0.9 percent.

Also during the fiscal year, we successfully implemented the first phase of our Investment Reconciliation process—a portfolio management and accounting system that will shadow the reconciliation efforts of our master custodian State Street Bank. With the assistance of Princeton Financial's portfolio asset management (PAM) software, CalPERS established a review of the System's internally managed fixed income, equity and cash investments. Phase II, targeted for completion in July 1999, will establish a secondary review of the externally domestic managed accounts. We were driven to establish the investment reconciliation process to help preserve the growth of the Fund and provide a second verification of the System's key investment accounting processes.

Building Shareowner Value

The year also marked the continued evolution and ongoing development of the System's U.S. and international corporate governance programs. For the first time, our Board of Administration adopted a formal set of U.S. Corporate Governance Principles and Guidelines. We believe these principles represent the foundation for accountability between a

corporation's management and its shareowners and will serve as a tool to further advance this relationship.

The principles include a definition of an independent director and a number of criteria that specify higher standards for individual directors. They also outline and recommend potential duties for an independent director and a lead independent director of a board.

We believe the criteria in these principles are important considerations for all companies within the U.S. market. We believe the accountability reflected in these principles is needed as American corporations compete in the next century. Our hope is that they will further strengthen the independence of America's boardrooms and influence the corporate governance movement toward greater consensus on corporate governance standards.

Our focus on principles that embody good corporate governance practices extended to our international corporate governance program as well. In addition to our already established principles for the United Kingdom and France, we adopted Corporate Governance Principles for Germany and Japan. They embody the growth and changes inherent in the corporate governance systems of these countries and will serve as a tool to assist us in monitoring our international investments while pursuing better corporate governance for the companies in which CalPERS invests.

Investments Operated at Low Cost to Members

Of equal importance, our excellent investment performance came at a low cost to the System. According to a study issued by Cost Effectiveness Measures, Inc. (CEM), the Fund's investment-related expenses were extremely cost effective, without sacrificing the quality of the investment program. The study concluded that CalPERS spent less than two-tenths of one percent of the Fund's value, \$108 billion in 1996, on investment related expenses. We achieved value-added investment results equal to or in excess of other large pension systems. Additionally, the study found that CalPERS investments are better diversified than its peers, with allocations to each of the major asset classes.

The Board has investment authority and sole responsibility for the management of assets. A complete set of policies serves as a guide for the Investment Committee, management, and staff for carrying out the daily activities of the investment program. Investment policies are formally reviewed through the System's Investment Policy Subcommittee and receive final approval by the Investment Committee.

One of our most important policies and investment strategies is our asset allocation decision. It is essentially the starting point, and most important component, for CalPERS to achieve successful returns on investments. It is ultimately the way the Fund diversifies stocks, bonds, cash, and other investments that is largely responsible for the System's returns. The allocation decision is not an asset-only or liability-only decision. All factors,

including liabilities and contributions, are taken into account in determining the appropriate asset allocation mix. The Board approves a target allocation with investment range guidelines for each asset class.

There are two types of asset allocations: strategic and tactical. Strategic asset allocation is the basis for long-term asset allocation targets for each asset class. Within each class, ranges are included in the policy to provide the flexibility to take advantage of market opportunities. Information is received from staff, research services, and money managers. This forms the tactical asset allocation which allows for shifts between asset classes to take advantage of emerging or rapid market opportunities.

In addition to the asset allocation policy, the following investment objectives have been established for the portfolio.

CALPERS ASSET ALLOCATION

(June 30, 1998)

ASSET CLASS	MARKET VALUE (\$ BILLION)	CURRENT ALLOCATION	TARGET
CASH EQUIVALENTS	1.5	1.0%	1.0%
FIXED INCOME			
DOMESTIC	32.5	22.7	24.0
INTERNATIONAL	5.1	3.6	4.0
TOTAL FIXED INCOME	39.1	27.3	29.0
EQUITIES			
DOMESTIC	67.5	47.1	41.0
INTERNATIONAL	26.8	18.7	20.0
ALT. INV./PRIVATE EQ.	3.7	2.6	4.0
TOTAL EQUITIES	98.0	68.4	65.0
REAL ESTATE	6.2	4.3	6.0
TOTAL FUND	\$143.3	100.0%	100.0%

CALPERS ASSET PERFORMANCE VS. BENCHMARK

(June 30, 1998)

ASSET CLASS	ASSET RETURN	BENCHMARK RETURN	BENCHMARK DESCRIPTION
CASH EQUIVALENTS	5.7%	5.6%	State Street Bank STIF
FIXED INCOME			
DOMESTIC	14.4	13.8	Salomon Brothers Large Pension Fund Index
INTERNATIONAL	4.9	0.9	Salomon Brothers Non-\$ World Government Index
TOTAL FIXED INCOME	13.0	11.8	Weighted benchmark based on current asset allocation target
EQUITIES			
DOMESTIC	29.4	29.7	Wilshire 2500
INTERNATIONAL	7.2	6.6	FT Actuaries/IFC Investable Index
ALT. INV./PRIVATE EQ.	35.9	15.0	15% Annual Hurdle Rate
TOTAL EQUITIES	22.8	22.8	Weighted benchmark based on current asset allocation target
REAL ESTATE	18.1	15.6	NCREIF Property Index
TOTAL FUND	19.5	19.5%	Weighted benchmark based on current asset allocation target

Inflation

Achieve a total portfolio return of 4 percent in excess of the U.S. Consumer Price Index.

Actuarial

Achieve a total portfolio return above the assumed actuarial interest rate, at 8.5 percent for the period July 1, 1997 through June 30, 1998.

Performance

1. For the internal equity index portfolio, achieve a return equal to the Wilshire 2500 Index, plus or minus 50 basis points.
2. For externally managed assets, meet specific performance objectives related to investment style, which are outlined in external manager contracts.

3. For internal fixed income instruments, achieve a return in excess of the Salomon Brothers Large Pension Fund Index.
4. For equity real estate, achieve at least a 5 percent real rate of return.
5. For alternative and private equity investments, achieve an annual hurdle rate of 15 percent.

Global Public Markets

Public market investments represent the largest portion of our investment portfolio. More than \$98.1 billion was invested in the U.S. and international equity markets and \$38.0 billion invested in domestic and international fixed-income at the end of the fiscal year.

Approximately 80 percent—or \$54.3 billion—of the Fund's domestic equity assets are passively managed internally and \$1.5 billion are managed by one external small capitalization passive manager, while the remaining 12 percent—or \$11.8 billion—are actively managed by 15 external money managers. The System's \$32.7 billion domestic fixed-income portfolio is managed internally, while all the Fund's international equity and fixed-income investments valued at \$29.9 billion are managed externally, using 16 investment managers.

During the year, CalPERS successfully completed and implemented a comprehensive investment strategy for its domestic equity investment program. The Fund selected 10 new active domestic equity managers to manage nearly \$10 billion of the System's domestic equity. The new firms exemplify some of the best investment expertise in the marketplace needed to add value to our investment portfolio.

Several significant structural changes were made to further enhance returns to the Fund. CalPERS new line-up of managers were allocated equity assets based on their management capacity to handle their assets. Managers are measured against new specialized

benchmarks that help identify immediate performance problems. Manager fees are tied to performance on a sliding fee schedule that prevents encouraging asset growth regardless of performance. These changes helped CalPERS attract effective firms and more closely align interests of the System with each manager.

DOMESTIC EQUITY INVESTMENTS

(\$ in Billions)

	MARKET VALUE	% OF PORTFOLIO
INTERNAL PORTFOLIOS	\$52.1	37.0%
EXTERNAL PORTFOLIOS	11.6	7.2
TOTAL	\$52.9	44.2%

Additionally, we added a specialized passively managed investment vehicle to our portfolio line-up. The vehicle—called a completion fund—is designed to complement the performance of active managers and manage risk by closing the loop between the Fund's strategic asset allocation decisions and tactical external manager decisions. It effectively fills any market "gaps" absent from the composite of external money managers' investment portfolios.

We maintained our passive portfolios as a sound foundation, sought out aggressive equity managers, and added a specialized investment portfolio that opened doors to new opportunities for the Fund. In addition, we began a strategic review of our international portfolios in order to keep pace with the changing global markets.

Alternative Investment Management Program

CalPERS witnessed improved efficiency in its Alternative Investment Management program since embarking on a major overhaul of the asset class during the last fiscal year. We streamlined our internal approval process from 180 to 155 days to allow the Fund to react quickly to market opportunities. We increased our investment commitment size from \$49 million to \$91 million. We adjusted our portfolio weightings consistent

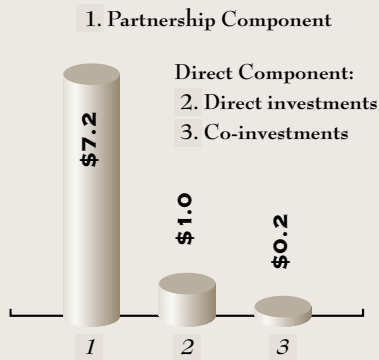
FIXED-INCOME INVESTMENTS

(\$ in Billions)

	MARKET VALUE	% OF PORTFOLIO
DOMESTIC	\$32.9	23.5%
INTERNATIONAL	5.1	3.3
TOTAL	\$38.0	26.7%

ALTERNATIVE INVESTMENT MANAGEMENT PORTFOLIO SUMMARY

(Committed \$ in Billions)



with the program's annual plan, reducing our exposure to domestic corporate finance and media and communications, while tapping private equity opportunities overseas. We increased our exposure to direct investing by completing five new co-investments.

Of utmost importance, we approved new investment strategies for our Partnership, Co-Investment, and Independently-Sourced investments. Market conditions were requiring us to be more selective and efficient. With a 14-year economic expansion and bull market, these strategies provided a foundation to find creative ways to put capital to work in the private equity market. The new strategies called for CalPERS to sharpen its focus on value added investments that build businesses. They included increasing venture capital investments and buyout partnerships that target small and emerging corporations; targeting California investments that capitalize on the state's strong economy and innovative technological advancement and entrepreneurship; seeking more international investments; and maintaining a continued focus on profitable general partnerships.

Consistent with these strategies, CalPERS entered into its largest private equity investment during the

year. We made a \$500 million investment in a \$1 billion partnership established by Enron Corporation. The new direct investment vehicle—coined Joint Energy Development Investment II (JEDI II)—invests in worldwide energy related properties and business focusing on the natural gas, crude oil, and electricity sectors. JEDI II marked the second investment made between CalPERS and Enron. In 1993, CalPERS made a \$250 million investment with the energy corporation to pursue investment in natural gas related businesses and properties in North America. During the year, we successfully concluded the investment, earning approximately a 23 percent internal rate of return.

At the end of the fiscal year, CalPERS Alternative Investment Management program had approximately \$7.2 billion in commitments to 105 partnership

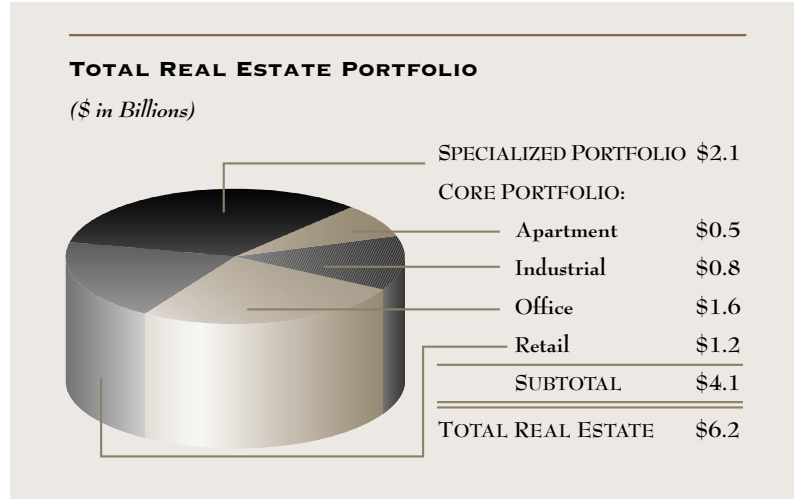
CALPERS INTERNATIONAL INVESTMENTS

UP TO \$25 MILLION	NEW ZEALAND
CHINA	PORTUGAL
CAYMAN ISLANDS	SINGAPORE
INDONESIA	TURKEY
LUXEMBOURG	
THAILAND	\$300 – \$500 MILLION
	BELGIUM
\$25 – \$50 MILLION	HONG KONG
AUSTRIA	SOUTH AFRICA
CHILE	
KOREA	\$500 MILLION – \$1 BILLION
NORWAY	CANADA
PHILIPPINES	SWEDEN
	SPAIN
\$50 – \$100 MILLION	
ARGENTINA	OVER \$1 BILLION
BRAZIL	AUSTRALIA
MALAYSIA	EUROPEAN CURRENCY UNIT
TAIWAN	FRANCE
	GERMANY
\$100 – \$300 MILLION	ITALY
DENMARK	JAPAN
FINLAND	NETHERLANDS
GREECE	SWITZERLAND
IRELAND	UNITED KINGDOM
MEXICO	

investments, of which over \$3.8 billion was invested. Approximately \$1.2 billion was committed to eight co-investments and three direct investments.

Real Estate

CalPERS completed implementation of a new strategy that changed the management structure and investment policy of our \$4.1 billion core real estate portfolio during the year. This included the selection and retention of new real estate firms to manage our apartment, office, industrial and non-mall retail properties. Each firm co-invests significant equity with CalPERS and operates under a philosophy that is consistent with our investment objectives. Additionally, these strategic alliances provided for a dedicated staff of investment professionals with expertise in the property sector and broad investment discretion, differentiating the relationship from the conventional advisory structure. The result was better and effective alignment of interests between



management and CalPERS, and an environment where responsibility and accountability are crystal clear.

The year also marked a first in our real estate portfolio. CalPERS made a \$100 million international real estate investment in Security Capital Global Realty, a Luxembourg-based private real estate corporation that invests in international real estate operating companies. This action offered us the ability to participate in another basket of investable opportunities that exist in foreign real estate markets and provided for greater diversification that helped to capture higher investments returns abroad.

By the end of the fiscal year, we had initiated a review and development of investment strategies for our remaining \$2.1 billion specialized real estate portfolio, devoted to assets such as timber, housing, land and other specialized programs. The System's total real estate portfolio earned a 13.8 percent return.

TOP TEN INTERNAL DOMESTIC EQUITY HOLDINGS

(As of June 30, 1998)

ISSUE	SHARES/PAR	MARKET VALUE BASE
GENERAL ELECTRIC CO.	15,281,000.00	\$1,390,571,000.00
MICROSOFT CORPORATION	11,388,800.00	1,234,261,200.00
COCA-COLA CO.	11,423,100.00	976,675,050.00
EXXON CORPORATION	11,309,500.00	806,512,412.50
MERCK & CO. INC.	5,498,900.00	735,477,875.00
PFIZER INC.	5,891,200.00	640,299,800.00
WAL MART STORES INC.	10,133,700.00	615,622,275.00
INTEL CORPORATION	7,737,700.00	573,557,012.50
PROCTER & GAMBLE CO.	6,108,904.00	556,292,070.50
INTERNATIONAL BUSINESS MACHINES	4,375,700.00	502,385,056.25

CalPERS was vigilant and successful in its campaign for good corporate governance during the year. We voiced our opinions through our proxy votes at a number of companies with poor corporate governance practices. CalPERS voted on proxies for over 1,600 domestic companies whose market value totaled \$60 billion and 740 international companies with a market value of \$24 billion. In total, we voted in favor of 78 percent and against 22 percent of the 2,589 domestic management proposals, and in favor of 58.5 percent and against 41.5 percent of the 299 shareholder proposals presented to vote.

Once again, our Corporate Governance Program employed a focused approach targeting 10 "focus" companies and increased monitoring of 16 other poorly performing companies.

The Fund received an unprecedented amount of support from shareowners of Sybase, Inc. to support our shareholder proposal that urged the California-based software company to adopt annual elections for the company's board of directors. The proposal passed

with the support of 67 percent of the votes cast at Sybase's annual meeting.

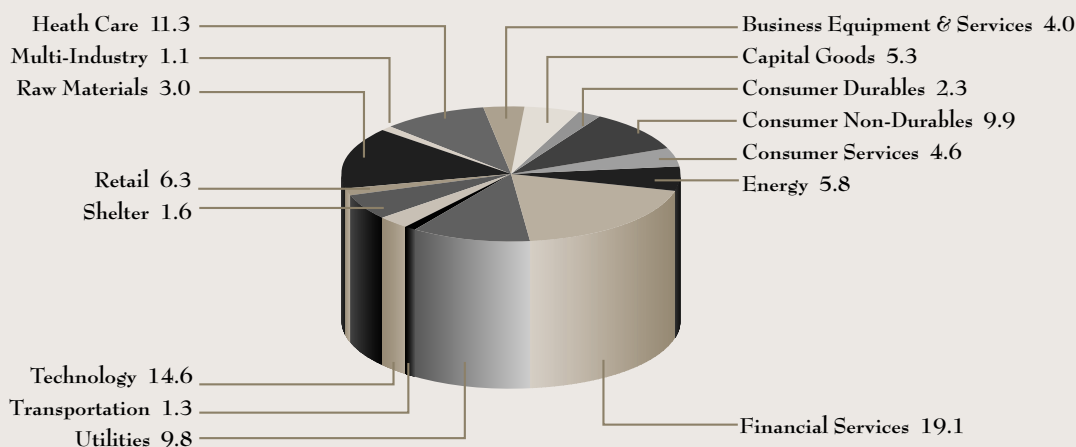
Shareowners during the year also defeated a Marriott International, Inc. management proposal that would have created a dual class stock structure. The win was hailed as a victory for CalPERS and all Marriott shareowners.

CalPERS garnered support from shareowners at a number of other companies. Despite strong efforts by management to kill CalPERS shareholder proposals, more than 21 percent of shareowners voted for the System's independent chair proposal at Electronic Data Systems, while 28 percent voted for the same proposal at Advanced Micro Devices. The System received 15 percent of the vote from shareowners on a shareholder proposal aimed at MAXXAM, Inc. that called for an end to the company's staggered system of electing directors.

In an effort to leverage our corporate governance efforts abroad, we extended our influence in the United Kingdom and approved a \$200 million

DOMESTIC EQUITY SECTOR DISTRIBUTION OF COMMON STOCK

Internally Managed Portfolios



investment to Active Value Capital, L.P. This investment fund seeks to use relationship investing to unlock shareowner value in underperforming British companies by using its influence as a large and active investor to affect financial and operational restructuring to increase value for all shareowners. We believe that the relationship investment strategy complements our current corporate governance policies abroad and will serve as an additional tactic to add value to the Fund's investment portfolio.

We hope that our work in corporate governance stimulates healthy debate. Our overriding goal is to assert our voice and share our experience in corporate governance. By working with investors, we hope that our voice and experience can help

1998 CORPORATE GOVERNANCE "FOCUS COMPANIES"

A. SCHULMAN	LOUISIANA PACIFIC CORPORATION
ADVANCED MICRO DEVICES	MICHAELS STORES
ELECTRONIC DATA SYSTEMS	STEWART & STEVENSON SERVICES
INTERNATIONAL FLAVORS AND FRAGRANCES	SYBASE
	TBC CORPORATION

America's corporate governance system grow in a way that maximizes long-term shareowner value.

CALPERS DEFINITION OF AN INDEPENDENT DIRECTOR

An "Independent Director" means a director who:

- has not been employed by the Company in an executive capacity within the last five years;
- is not, and is not affiliated with a company that is, an adviser or consultant to the Company or a member of the Company's senior management;
- is not affiliated with a significant customer or supplier of the Company;
- has no personal services contract(s) with the Company, or a member of the Company's senior management;
- is not affiliated with a not-for-profit entity that receives significant contributions from the Company;
- within the last five years, has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;
- is not employed by a public company at which an executive officer of the Company serves as a director;
- has not had any of the relationships described above with any affiliate of the Company; and
- is not a member of the immediate family of any person described above.

CalPERS invests more than \$15 billion into California's economy through its equity investments, real estate holdings, home loan programs, and other economic activity. We have become a critical part of the economic fabric of the state. From the San Francisco Bay Area, to the Central Coast, down the state to the greater Los Angeles region, our investments help build houses, finance homes, and provide the funds that pay for thousands of private-sector jobs.

We invest more than \$9.1 billion in companies based in California—from blue-chip corporations on the New York Stock Exchange to start-up firms in South Central Los Angeles and the Silicon Valley. Our real estate holdings and mortgages finance \$2.3 billion worth of single family homes and general real estate holdings, while our fixed income assets, largely held in government bonds and corporate bonds, amount to about \$4 billion.

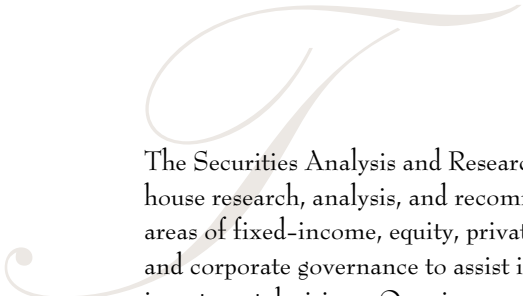
Fulfilling our commitment to seek investments that strengthen California's economy, the Board set aside up to \$350 million for new venture capital investments during the year. The assets, which will be invested through a third party retained by CalPERS, are expected to be deployed in California given the high concentration of venture capital funds and high technology companies that make their home in California. The new fund looks

to be a win-win for CalPERS and California. The infusion of capital could mean the creation of more jobs and greater capital flow to California, while providing CalPERS the opportunity to earn attractive returns through innovative technological advancements in California.

CALPERS CALIFORNIA INVESTMENTS

Regional Profile





The Securities Analysis and Research Unit provides in-house research, analysis, and recommendations in the areas of fixed-income, equity, private equity, real estate, and corporate governance to assist in making investment decisions. Ongoing monitoring of fixed-income securities and real estate transactions includes annual industry reviews. Staff review all existing fixed-income holdings and provide an industry overview.

The research unit also provides the initial screening, analysis, and recommendation regarding the selection of underperforming companies for the CalPERS corporate governance activities and provides analysis on selected target companies. Other duties include review of corporate actions, including mergers, acquisitions, and tender offers, as well as review of private equity transactions.

P R O F I L E

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund and the second largest in the world, with assets at June 30, 1998 of \$143.3 billion.

Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1 million people and more than 2,400 public employers. The System also operates seven offices located in San Francisco, Los Angeles, Orange County, San Bernardino, San Diego, Mountain View, and Fresno.

CalPERS is led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex-officio members.

Our membership consists of 776,333 active and inactive members from the State, school districts, and local public agencies, and 331,622 retirees, beneficiaries, and survivors.

Established by legislation in 1931, the System became operational in 1932 for State employees only. In 1939, other public agencies were allowed to contract with CalPERS to provide retirement benefits for their employees. We began administering health benefits to State employees in 1962 under the Public Employees' Medical and Hospital Care Act. Local public agencies joined in our health program on a contract basis five years later.

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Sheryl Pressler

ASSISTANT EXECUTIVE OFFICER
INVESTMENT OPERATIONS
Robert Aguallo



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